IN THE UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF VIRGINIA
Newport News Division

GREGG KIKEN, et al., Individually and on Behalf of All Others Similarly Situated, Plaintiffs, v. LUMBER LIQUIDATORS HOLDINGS, INC., et al., Defendants.	No. 4:13-cv-00157-AWA-DEM Hon. Arenda L. Wright Allen CLASS ACTION

MEMORANDUM IN SUPPORT OF DEFENDANTS' MOTION TO DISMISS PLAINTIFFS' SECOND AMENDED COMPLAINT

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Lumber Liquidators Holdings, Inc. ("Lumber Liquidators" or the "Company"), Robert M. Lynch, Daniel E. Terrell, Thomas D. Sullivan, and William K. Schlegel ("Individual Defendants"; with Lumber Liquidators, "Defendants"), hereby move to dismiss Plaintiffs' Complaint with prejudice under Federal Rule of Civil Procedure 12(b)(6).[1]

INTRODUCTION

Lumber Liquidators is the largest specialty retailer of hardwood flooring in North America. In 2012 and 2013, the Company expanded its operations and enjoyed unprecedented financial success. As a result, the Company's stock price increased significantly, nearly doubling in 2013 alone. In conjunction with this rise in fortunes, however, the Company also attracted some negative publicity.

In June 2013, an internet post alleged that based on the author's testing of a single box of Lumber Liquidators flooring, the Company might not be in compliance with formaldehyde emissions standards. Subsequently, in September 2013, the U.S. government (after prompting from an environmental group) launched an investigation into whether the Company had imported any illegally harvested wood. Finally, a short seller gave a public presentation in November 2013 stating that, in his opinion, the alleged (but unproven) formaldehyde and illegal harvesting issues could disrupt the Company's supply chain and impact its margins.

Based on these items, Plaintiffs have concocted an entire theory of securities fraud. According to Plaintiffs, Lumber Liquidators defrauded its investors by failing to tell them that a "substantial portion" of the Company's revenue was earned by widespread violations of regulatory laws and the Company therefore would be unable to sustain its margins. The key problem for Plaintiffs, however, is that none of the negative publicity has turned out to have any merit. Lumber Liquidators has never reported that any of the regulatory violations actually occurred, and no government investigation has ever found that any regulatory violations occurred. Plaintiffs are reduced to asserting that because Lumber Liquidators has been *accused*

[1] "Complaint" or "Compl." refer to Plaintiffs' Second Amended Complaint. ECF No. 29.

of having engaged in regulatory violations and, in the opinion of one investor, those violations could impact the Company's margins, that is enough to adequately allege that (a) widespread regulatory violations occurred and (b) the Company's senior officers knew about the widespread regulatory violations and hid their financial impact from investors. Plaintiffs are wrong.

Under the Private Securities Litigation Reform Act of 1995 (the "PSLRA"), securities fraud claims are subject to heightened pleading standards that Plaintiffs completely fail to meet. First, Plaintiffs do not provide any particularized facts demonstrating that Lumber Liquidators' statements about its regulatory compliance and financial performance were false. Not only do Plaintiffs fail to adequately allege that widespread regulatory violations occurred, but even if they had occurred, Defendants would have had no duty under the securities laws to disclose them. Second, Plaintiffs do not, because they cannot, plead the required strong inference of scienter as to any of the Defendants. The Complaint is devoid of any allegations as to how Defendants knew, or were severely reckless in not knowing, about any regulatory violations or their financial impact. Plaintiffs also fail to demonstrate anything suspicious about the timing of the Individual Defendants' stock sales. Finally, Plaintiffs cannot establish loss causation based on allegations that stock price declines occurred as the result of the internet post, the announcement of the government investigation, or the short seller presentation. While these disclosures created negative publicity for the Company, they were not "corrective disclosures" that provided the required "new facts" alerting the market to the fraud alleged in the Complaint.

Securities fraud claims do not exist "to provide investors with broad insurance against market losses." *Dura Pharm., Inc. v. Broudo,* 544 U.S. 336, 345 (2005). If a successful case could be brought every time a company is accused of having engaged in regulatory violations, the courts would be awash with securities litigation. Plaintiffs have failed to provide *any* facts to support their assertion that Defendants engaged in a fraudulent scheme to import illegal wood products and then hid that scheme from investors. Indeed, this is exactly the type of baseless securities fraud claim that Congress sought to prevent when it passed the PSLRA. Defendants respectfully request that the Court dismiss Plaintiffs' claims with prejudice.

BACKGROUND[2]

I. The Company's Business

Lumber Liquidators is the largest specialty retailer of hardwood flooring in North America. (2013 Form 10-K at 4, Ex. 1; *see also* Compl. ¶ 54.) As of December 2013, the Company operated 318 retail stores in the United States and Canada. (*Id.*) The Company offers an extensive assortment of exotic and domestic hardwood species, engineered hardwood, laminate, vinyl plank, bamboo, and cork direct to the consumer. (*Id.*) It also provides a wide selection of flooring enhancements and accessories, including moldings, noise-reducing underlay, adhesives, and flooring tools. (2013 Form 10-K at 4, Ex. 1.) The Company's primary customers are homeowners or contractors acting on behalf of homeowners. (2013 Form 10-K at 4, Ex. 1; *see also* Compl. ¶ 54.)

The Company is well-diversified in its product sources, both in terms of geography and number of suppliers. From 2011 to 2013, approximately half of the Company's sales were of products sourced in North America, with the other half coming from Asia (plus a small additional percentage from South America). (2013 Form 10-K at 6, Ex. 1.) In 2013, 41% of these products were hardwood (solid and engineered), with only 1.6% of that hardwood consisting of oak purchased from northern China. (CSFB presentation at 24, attached to the Company's December 9, 2013 Form 8-K, Ex. 2.) In addition, no single supplier provided more than 4% of the Company's hardwood purchases.[3] (3Q 2013 Form 10-Q at 10, Ex. 3.)

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[2] As is permitted in securities fraud cases, this factual background is drawn from all well-pleaded facts, judicially noticed matters, and documents central to or referred to in the Complaint. On a motion to dismiss, "there are exceptions to the rule that a court may not consider any documents outside of the complaint. Specifically, a court may consider official public records, documents central to plaintiff's claim, and documents sufficiently referred to in the complaint so long as the authenticity of these documents is not disputed." *Witthohn v. Fed. Ins. Co.*, 164 Fed. App'x 395, 396 (4th Cir. 2006) (unpublished). Courts also may take "judicial notice of the content of relevant SEC filings and other publicly available documents." *Yates v. Mun. Mortgage & Equity, LLC*, 744 F.3d 874, 881 (4th Cir. 2014). These publicly available documents can include newspaper articles, press releases, transcripts from conference calls, analysts' reports, and stock prices. *See. e.g.*, *Johnson v. Pozen Inc.*, 2009 WL 426235, at *1-2 (M.D.N.C. Feb. 19, 2009); *see also Greenhouse v. MCG Capital Corp.*, 392 F.3d 650, 655 n.4 (4th Cir. 2004). All exhibits referred to in this Memorandum are exhibits to the Declaration of Lyle Roberts in support of the Motion to Dismiss.

A number of changes to Lumber Liquidators' business from 2011 to 2013 led to an increase in the Company's gross margins from 35.3% to 41.1%.[4] (Compl. ¶ 103; 2013 Form 10-K at 28, Ex. 1.) These changes included a series of "sourcing initiatives" designed to reduce the cost of its products. (Compl. ¶ 59.) The sourcing initiatives covered three primary areas: (1) volume-based discounts and cost sharing with the Company's suppliers in areas such as marketing, product samples, and new store openings; (2) engaging with mills in competitive line reviews of specific merchandise categories to evaluate product assortment, quality, logistics, and cost; and (3) direct sourcing from mills to better control product cost and quality, enhance forecasting, and broaden product assortment.[5] (Compl. ¶ 149.)

Although the sourcing initiatives and related decline in product costs were an important part of the gross margins increase, they were not the only factor. (2013 Form 10-K at 28-29, Ex. 1.) Of the 6.1 percentage point increase in gross margin between 2011 and 2013, only 1.5 to 2 percentage points were attributable to the sourcing initiatives. (CSFB presentation at 20, 24, attached to the Company's December 9, 2013 Form 8-K, Ex. 2.) Most of the increase—2.5 to 4 percentage points—was attributable to changes in the Company's overall sales mix, including an increase in the average selling price for its products.[6] (*Id.*)

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[3] In their Complaint, Plaintiffs assert that Lumber Liquidators "has stated in its SEC filings [that] any single mill may provide as much as 4% of its hardwood purchases." (Compl. ¶ 79.) This appears to be a deliberate misreading of the Company's disclosures in an attempt to artificially inflate the *potential* amount of hardwood that was purchased from any one supplier. The Company clearly refers to "supplier," not "mill" in discussing this statistic. A supplier could have a single mill or many mills. (*See* 3Q 2013 Form 10-Q at 10, Ex. 3.)

[4] Gross margin is a "company's total sales revenue minus its cost of goods sold, divided by the total sales revenue, expressed as a percentage. The gross margin represents the percent of total sales revenue that the company retains after incurring the direct costs associated with producing the goods and services sold by a company. The higher the percentage, the more the company retains on each dollar of sales to service its other costs and obligations." *See* Investopedia, "Gross Margin," http://www.investopedia.com/terms/g/grossmargin.asp (last visited Aug. 18, 2014).

[5] As part of the implementation of these initiatives, in September 2011, the Company acquired certain assets of Sequoia Floorings ("Sequoia") related to Sequoia's quality control and assurance, product development, and logistics operations in China. (*Id.* ¶ 61.) Whereas Lumber Liquidators previously had used Sequoia to provide sourcing services for most of its purchases from China suppliers, the Company was now able to have a direct relationship with these suppliers. (*Id.* ¶ 61-62.) In addition, it reduced its costs by no longer having to pay Sequoia to act as a middleman in the purchasing process. (*Id.* ¶ 151 (cost of product declined, in part, due to "net cost reduction of owning those [Sequoia] services").)

Lumber Liquidators competes against both local flooring retailers and national home improvement warehouse chains (*e.g.*, Home Depot and Lowe's) in selling hardwood flooring to consumers. (Compl. ¶ 103.) Home Depot and Lowe's, however, also sell a vast array of other products, including building materials, home improvement products, paint, lawn and garden items, and related services. (The Home Depot 2012 Form 10-K at 1, Ex. 4; Lowe's 2012 Form 10-K at 6, Ex. 5.) Indeed, Lumber Liquidators estimates that its "product categories represent less than 2% of sales at an average Home Depot or Lowe's store." (2013 Form 10-K at 8, Ex. 1.) When Home Depot or Lowe's provides investors with its gross margins, as cited in the Complaint at paragraphs 58 and 103, those gross margins reflect the product costs and sales revenues for *all* of the products sold by those companies, not just hardwood flooring.

II. The Regulatory Environment for Wood Products

As an importer and seller of hardwood flooring, Lumber Liquidators is subject to numerous environmental regulations. These environmental regulations include: (a) the Lacey Act, 16 U.S.C. §§ 3371-3378, which bans the import and trade of illegally sourced wood products (including wood products sourced in violation of foreign laws), and (b) regulations related to formaldehyde emissions from wood products as established by the California Air Resources Board ("CARB"), Cal. Code. Regs., tit. 17, § 93120, *et seq.* (Compl. ¶¶ 36-39, 47-53.)

The Lacey Act requires importers of wood products to exercise "due care" in identifying illegally harvested wood, and companies found to have imported such wood can be subject to civil or criminal sanctions. (Compl. ¶ 39.) The Lacey Act does not itself, however, ban the importation of wood products from any particular geographic area. The relevant issue is whether the taking of the particular wood products at issue was illegal under the laws of the country where they were harvested, not whether the harvesting had an environmental impact.

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[6] Average selling price is the "price a certain class of good or service is typically sold for. Average selling price is affected by the type of product and the product life cycle." *See* Investopedia, "Average Selling Price," http://www.investopedia.com/terms/a/averagesellingprice.asp (last visited Aug. 18, 2014).

CARB sets limits on how much formaldehyde may be emitted from composite wood products, which often use resins that contain formaldehyde. (Compl. ¶¶ 48, 51.) CARB requires that all hardwood plywood products sold in the state of California should emit no more than 0.05 ppm (parts per million) of formaldehyde, as determined by particular testing methods. (*See id.* ¶ 52.) There is a third-party certification process for CARB compliance. (*Id.* ¶ 53.)

Lumber Liquidators has publicly recognized the need to work with its suppliers to comply with these environmental regulations. As the Company repeatedly disclosed throughout the alleged class period, "certain of our products are subject to laws and regulations relating to the importation, acquisition or sale of illegally harvested plants and plant products and the emissions of hazardous materials. We work closely with our suppliers to ensure compliance with the applicable laws and regulations in those areas." (Compl. ¶¶ 112, 155.) The Company's quality control and assurance efforts include having compliance processes that are performed and monitored by approximately 60 professionals around the world, including in China. (*Id.* ¶¶ 178, 188.) The Company also augments its on-site efforts with additional testing in its own labs and in independent certified facilities. (*Id.* ¶ 178.)

Both Lacey Act and CARB compliance, however, depend heavily on a company's suppliers. It is the suppliers who control both the location where trees are harvested and the manufacturing process that uses resins containing formaldehyde. As a result, Lumber Liquidators has consistently warned investors that "while our suppliers agree to operate in compliance with applicable laws and regulations, including those relating to environmental and labor practices, we do not control our suppliers. Accordingly, we cannot guarantee that they comply with such laws and regulations or operate in a legal, ethical, and responsible manner." (2011 Form 10-K at 13, Ex. 6; 2012 Form 10-K at 13, Ex. 7.) If the Company's suppliers were to violate applicable environmental laws it could "reduce demand for our products if, as a result of such violation or failure, we were to attract negative publicity" or "expose us to legal risks as a result of our purchase of products from non-compliant suppliers." (*Id.*)

III. Negative Publicity Regarding CARB and Lacey Act Compliance

In 2013, Lumber Liquidators reported record financial results, both for net sales and net income. (Compl. ¶¶ 144, 171, 191.) In light of these results, the Company's stock price consistently rose throughout the year, starting at $53.55 on January 2, 2013, rising to a high of $117.20 on November 13, 2013, and closing at $102.89 on December 31, 2013. (LL Stock Price Chart for 2013, Ex. 8.) Investors in Lumber Liquidators stock obviously did well. If an investor purchased Lumber Liquidators stock at the very beginning of the class period ($20.06 at the time of market open on Feb. 22, 2012) and sold her stock at the very end of the class period ($101.81 at the time of market close on November 22, 2013), that investor would have ended up with a staggering *five times* what she started with. (*Id.*) Nevertheless, there were a few times in 2013 when the Company's stock price experienced small interim declines.

On June 20, 2013, Xuhua Zhou, a stock market investor and self-described graduate student "dropout," made a post on the SeekingAlpha.com website about Lumber Liquidators' CARB compliance (the "Zhou Post"). (Compl. ¶ 167; *see also* "Xuhua Zhou," http://seekingalpha.com/author/xuhua-zhou (last visited Aug. 18, 2014).) Seeking Alpha is an investment website that accepts posts from public "contributors," who are then paid, in part, based on how many people choose to view the posts. (*See* Seeking Alpha, "Article Submission Guidelines," http://seekingalpha.com/page/article-submission-guidelines (last visited Aug. 18, 2014).) As disclosed by Seeking Alpha, Zhou held a short position in Lumber Liquidators' stock—*i.e.*, he stood to make money if the Company's stock price declined. (Zhou Post at 1, Ex. 9.) Although Zhou did not claim to have any particular expertise in wood or formaldehyde emissions, he stated in his post that he engaged independent labs to test two samples of Lumber Liquidators' wood products, bought at a single store, for formaldehyde emissions. One of the samples supposedly emitted formaldehyde at 3.5 times the permitted level; the other sample tested within the CARB limits (a fact that is carefully omitted from the Complaint's summary of the article). (*Id.* at 6-7; Compl. ¶¶ 168-69.) From July 19, 2013 to July 21, 2013, Lumber Liquidators' stock price declined from $86.03 to $76.63. (Compl. ¶ 170.)

After the publication of the Zhou Post, investment analysts immediately began to question the validity and import of the author's testing results. Piper Jaffray issued a "hot comment" on July 21, 2013, noting that it was "comforted that quality control is taken very seriously by the company" and opining that "the author's own testing of product may suffer from sampling error." (Piper Jaffray, Hot Comment, June 21, 2013 at 1, Ex. 10.) For its part, Credit Suisse found that "at this point it appears not to be an issue at all as the company has significant controls in place that make the likelihood of a product issue very small." (Credit Suisse, June 26, 2013 at 1, Ex. 11.) Piper Jaffray continued to look into the testing and, in a subsequent report, stated: "Our contact with a member of the California Air Resources Board (CARB) several months ago revealed the formaldehyde claims were based on testing that was non-compliant with industry standards. The test results from Berkley Analytics posted online were *neither valid nor a concern* b/c current CARB regulations pertain only to particle board, and not the veneer finish of floorboards—which was also tested in this instance." (Piper Jaffray, Oct. 7, 2013 at 1, Ex. 12 (emphasis added).) By July 12, 2013, just a few weeks after the appearance of the Zhou Post, Lumber Liquidators' stock was again trading above $86 per share.

On September 26, 2013, federal agents executed search warrants related to the importation of certain wood products at Lumber Liquidators' corporate offices in Toano and Richmond, Virginia. (Compl. ¶ 185.) The following trading day, Lumber Liquidators' stock price declined from $112.96 to $107.13. (Compl. ¶ 187.) According to a subsequent *Wall Street Journal* article (Ex. 13), the search warrants were prompted by an environmental group called the Environmental Investigation Agency ("EIA") providing the government with an advance copy of a report that discussed Lumber Liquidators (the "EIA Report").[7] (*Id.* ¶ 190.)

The EIA Report, which was issued to the public on October 11, 2013, concerns hardwood logging in the Russian Far East ("RFE"). Logging in the RFE is permissible if done pursuant to valid permits, but the World Wildlife Fund has concluded that "at least 50% of the oak exported in 2010 was illegally harvested."[8] (EIA Report at 7.) The EIA investigated the trade in RFE hardwoods and alleges that one of the major purchasers of illegal RFE oak is a wood-flooring company called Suifenhe Xingjia Economic and Trade Company ("Xingjia"). (EIA Report at 6 ("Xingjia's oak supplies are riddled with illegal sources.").) According to the report, Xingjia admitted to EIA that it illegally cuts outside of its concession boundaries, overcuts within those boundaries, and purchases over 90% of its stock from RFE trading companies that do not provide the required proof of legality of sourcing. (Compl. ¶ 80; EIA Report at 5.) An affiliate of Xingjia was one of Lumber Liquidators' suppliers of wood products. While the EIA Report is sharply critical of Lumber Liquidators' business relationship with Xingjia, it does *not* allege that (a) any actual wood purchased by Lumber Liquidators was illegally harvested, or (b) Lumber Liquidators knew about any harvesting issues with Xingjia's oak products. Indeed, the EIA merely concludes, based on pure speculation, that Lumber Liquidators "would have learned of the known high risk of illegally sourced timber in the RFE and known illegal actions of Xingjia and its suppliers" if it had "asked appropriate questions." (EIA Report at 21.)

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[7] The EIA Report is attached to the Complaint as Exhibit A.

Once again, investment analysts reacted skeptically to this negative publicity. Credit Suisse opined that "while the allegations and investigation could be serious charges, from an investment perspective we do not believe there was any deliberate attempt to violate legal requirements." (Credit Suisse, Sept. 27, 2013 at 1, Ex. 14.) Piper Jaffray noted that "no formal charges have been placed against LL" by the government. (Piper Jaffray, Sept. 27, 2013 at 1, Ex. 15.) Moreover, even if "one or several of the company's 110 mills could be in violation, we believe the issue is contained to a select few if any and not a problem with the entire supply chain." (*Id.*) And, as with the CARB allegations, within a few weeks of the execution of the search warrants the Company's stock price again was trading above $112 (on October 23, 2013, the closing price was $113.99). (*See* Ex. 8.) Since September 26, 2013, nearly a year ago, there has been no further public activity by the government related to its investigation.

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[8] In one of many efforts to stretch the facts, the Complaint states that according to the World Wildlife Fund "approximately 75% of oak exports" from the RFE "were illegal in origin." (Compl. ¶ 44.) As the EIA report makes clear, however, that number is for the earlier 2007-2008 period, which obviously is not relevant given that the alleged class period in this case begins in 2012. (EIA Report at 7.)

Finally, on November 22, 2013, a hedge fund manager named Whitney Tilson, who held a short position in Lumber Liquidators' stock, gave a presentation opining that the stock was overvalued (the "Tilson Presentation"). (Tilson Presentation at 18-19, Ex. 16.) The presentation was predicated entirely on existing public information about Lumber Liquidators, including the Zhou Post, the EIA report, and the Company's financial disclosures. Tilson concluded that "any disruption to Lumber Liquidator's supply chain and/or margins could result in the stock being cut in half." (*Id.* at 19.) On the day of the presentation, the Company's stock price declined from $115.95 to $101.81.[9] (Compl. ¶ 198.)

ARGUMENT

I. The Pleading Standards for Securities Fraud are Unusually Strict

Plaintiffs' principal claim arises under Section 10(b) of the Securities Exchange Act, 15 U.S.C. § 78j(b), and SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (a "Rule 10b-5 claim"). (*See* Compl. ¶¶ 82-91.) To successfully state a Rule 10b-5 claim, a plaintiff must establish: (1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 157 (2008).

It is not enough, however, for a plaintiff to engage in notice pleading. A federal securities fraud claim is subject to various heightened pleading standards. A plaintiff must satisfy Federal Rule of Civil Procedure 9(b), which requires fraud claims to be pled "with particularity." The particularity requirement means that a plaintiff must plead "the time, place, and contents of the false representations, as well as the identity of the person making the misrepresentation and what he obtained thereby." *In re Mut. Funds Inv. Litig.*, 566 F.3d 111, 120 (4th Cir. 2009) (internal quotation marks omitted), *rev'd on other grounds sub nom. Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011).

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[9] Although the class period ends in November 2013, Plaintiffs also assert that Lumber Liquidators' poor financial performance in the first two quarters of 2014 occurred because the Company "ha[d] been unable to increase its margins at the same dramatic rate following disclosure of the scheme." (Compl. ¶ 200.) Plaintiffs do not describe, and make no effort to rebut with contrary factual allegations, the Company's actual description of the reasons behind its decline in gross margin. As noted in the Company's 2Q 2014 earnings release, "[g]ross margin in the second quarter of 2014 is expected to contract in comparison to the second quarter of 2013 due primarily to adverse net shifts in sales mix and greater discounting at the point of sale." (2Q 2014 earnings release, July 30, 2014, Ex. 17.) In other words, gross margins contracted due to a reduction in sales revenues and *not* an increase in product costs relating to the Company's supposed inability to purchase cheaper, illegal wood products.

In addition, Congress enacted the PSLRA with the specific objective of discouraging "speculative lawsuits," *In re Cable & Wireless, PLC*, 321 F. Supp. 2d 749, 761 (E.D. Va. 2004), and "derailing frivolous, lawyer-driven litigation." *Cozzarelli v. Inspire Pharm. Inc.*, 549 F.3d 618, 624 (4th Cir. 2008). To that end, the PSLRA reaffirms and augments Fed. R. Civ. P. 9(b) by requiring a plaintiff to "specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, . . . state with particularity all facts upon which that belief is formed." 15 U.S.C. § 78u-4(b)(1).

The PSLRA also requires that a plaintiff must, "with respect to each act or omission alleged to violate [the securities laws], state with particularity facts giving rise to a *strong inference* that the defendant acted with the required state of mind"—*i.e.*, scienter. 15 U.S.C. § 78u-4(b)(2)(A) (emphasis added). To meet this requirement, "a plaintiff must allege that the defendant made the misleading statement or omission intentionally or with 'severe recklessness' regarding the danger of deceiving the plaintiff."[10] *Teachers' Ret. Sys. of La. v. Hunter*, 477 F.3d 162, 183 (4th Cir. 2007). "A plaintiff must allege facts that support a 'strong inference' that *each* defendant acted with at least recklessness in making [each] false statement." *Hunter*, 477 F.3d at 183 (emphasis in original).

"An inference of scienter can only be strong when it is weighed against the opposing inferences that may be drawn from the facts in their entirety." *Yates*, 744 F.3d at 885 (internal punctuation omitted). Thus, evaluating whether a strong inference of scienter has been pled "necessarily [entails] a comparative inquiry." *Id.* "The question is whether the allegations in the complaint, viewed in their totality and in light of all the evidence in the record, allow [the court] to draw a strong inference, at least as compelling as any opposing inference," that a defendant acted knowingly or with severe recklessness. *Id.* "When the facts as a whole more plausibly suggest that the defendant acted innocently—or even negligently—rather than with intent or severe recklessness, the action must be dismissed." *Cozzarelli*, 549 F.3d at 624.

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[10] "In the § 10(b) context, a reckless act is one that is so highly unreasonable and such an extreme departure from the standard of ordinary care as to present a danger of misleading the plaintiff to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it." *Yates v. Mun. Mortgage & Equity, LLC*, 744 F.3d 874, 884 (4th Cir. 2014).

Complaints that fail to meet these heightened pleading standards *must* be dismissed. *See* 15 U.S.C. § 78u-4(b)(3)(A).

II. Plaintiffs Fail to Adequately Plead that Defendants Made Any False Statements

The Complaint contains no well-pled allegations establishing that Defendants made any false or misleading statements during the alleged class period concerning either Lumber Liquidators' compliance with environmental laws or its financial performance. Accordingly, the Court should dismiss Plaintiffs' claims.

A. Plaintiffs Engage in Impermissible "Shotgun Pleading"

The PSLRA has exacting requirements for pleading "falsity" that require a plaintiff to specify each statement alleged to have been misleading and the specific reasons why that statement is misleading. 15 U.S.C. § 78u–4(b)(1). Here, the Complaint contains forty-two paragraphs of block quotations from Lumber Liquidators' public disclosures that are alleged to have been misleading. (Compl. ¶¶ 104-202.) These forty-two paragraphs contain dozens of statements. For example, paragraph 142 *alone* contains five separate statements. The Complaint then simply alleges that all of these dozens of statements are false for the general list of reasons cited in paragraph 104. (*See, e.g.*, Compl. ¶¶ 142-143; *see generally* Compl. ¶¶ 104-202.) Plaintiffs make no effort to delineate why any particular statement was misleading or even, as threshold matter, to identify whether any particular statement is alleged to be either affirmatively false or rendered misleading by a material omission. The Complaint is a textbook example of "shotgun pleading" and is subject to dismissal on that basis alone. *See Negron-Bennett v. McCandless*, 2013 WL 3873659, at *4 (E.D. Va. July 24, 2013) (dismissing complaint as "classic example of shotgun pleading"); *In re Metro. Sec. Litig.*, 532 F. Supp. 2d 1260, 1279 (E.D. Wash. 2007) ("A complaint is deficient for the purposes of Rule 9(b) when it relies on 'shotgun' or 'puzzle' pleading.").

B. Plaintiffs Fail to Adequately Allege that Lumber Liquidators Committed Widespread CARB or Lacey Act Violations

Although Plaintiffs' "shotgun pleading" makes it virtually impossible to address their allegations of falsity on a statement-by-statement basis, it is clear that this Court can dismiss the Complaint without going through that exercise. The gravamen of Plaintiffs' falsity allegations is that Lumber Liquidators engaged in widespread CARB and Lacey Act violations for the purpose of obtaining cheap wood and increasing profits. (*See, e.g.,* Compl. ¶ 104; Pl.'s Reply in Further Supp. of Lead Pl. App. at 4 ("The Complaint alleges an *overarching scheme* by Defendants to defraud investors by failing to disclose a course of conduct whereby Defendants *consistently* violated federal law, including the Lacey Act and regulations governing formaldehyde emissions, in order to profit from cheaper wood in an attempt to increase profits.") (emphasis added).) Lumber Liquidators' failure to disclose these alleged violations then supposedly rendered all of its statements concerning regulatory compliance and financial results false. (*See* Compl. ¶¶ 104-202.) Plaintiffs do not, because they cannot, plead any factual allegations establishing that Lumber Liquidators engaged in widespread CARB or Lacey Act violations.

As a threshold matter, Lumber Liquidators has never disclosed the existence of any CARB or Lacey Act violations. Nor has any government investigation concluded that these types of violations occurred. Moreover, Plaintiffs interviewed a series of former Lumber Liquidators employees who allegedly worked in senior positions at the Company and are familiar with its China operations. (Compl. ¶¶ 67-72.) But *none* of these former employees claim, even anonymously, that Lumber Liquidators engaged in CARB or Lacey Act violations or even that the Company had any deficiencies in its regulatory compliance program. *See, e.g.*, *In re ECI Telecom Ltd. Sec. Litig.*, CV No. 01-913-A, slip op. at 7 (E.D. Va. Nov. 11, 2001), Ex. 18 ("Because plaintiffs clearly have obtained the cooperation of former [defendant] employees, this Court expects that plaintiffs should be able to articulate these claims with the requisite specificity."); *City of Royal Oak Ret. Sys. v. Juniper Networks, Inc.*, 880 F. Supp. 2d 1045, 1064 (N.D. Cal. 2012) (dismissing complaint where plaintiffs "fail[ed] to allege facts that provide an analytical link between the particular facts supplied by the confidential witness and the ultimate conclusion that Juniper could not meet its overall revenue and growth goals").

Accordingly, the sole basis for Plaintiffs' allegations of widespread CARB and Lacey Act violations are the Zhou Post, the EIA Report, and the Company's gross margin increase as compared to Home Depot and Lowe's. But what do those items actually demonstrate about the existence of violations? The Zhou Post involves the testing of two samples of Lumber Liquidators' wood products, bought at a single store, for formaldehyde emissions. (Zhou Post at 5-7, Ex. 9.) One sample supposedly violated CARB; the other sample was compliant. (*Id.* at 6-7.) Putting aside the serious criticisms concerning the validity of this testing (*see* Background, *supra*), at best the Zhou Post demonstrates that one box of flooring, out of millions of boxes of flooring sold every year by Lumber Liquidators, may have emitted excess formaldehyde. That conclusion, even if accurate, obviously provides no support for Plaintiffs' key falsity allegation that the Company "consistently" violated CARB.[11]

The EIA Report also fails to establish the validity of Plaintiffs' theory of falsity. As the EIA Report and the statements in the Complaint from CW5 ("a member of EIA") make clear,

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[11] Zhou himself frames his analysis in terms of "risks." After presenting the results of his "tests," Zhou goes on to state that, as a result, "investors in Lumber Liquidators should be aware of the following *risks* facing the Company: 1. Amount of installed product in customers' homes and businesses to be removed and replaced – *unknown*; 2. Amount of product to be withdrawn from inventory – *disposition and costs unknown* …." (Zhou Post at 8, Ex. 9 (emphasis added).) Zhou does not even attempt to predict, based on the insignificant sample size he employed, whether and to what extent *any other* Lumber Liquidators products may or may not exceed CARB limits. Indeed, in concluding his post, Zhou notes that he only found one "non-compliant batch of product" out of a "total of three samples," and he then exclaims, "What does it mean? Could this be a near-meaningless oversight or could it be 'the floater in the punchbowl?'" (*Id*. at 9.)

EIA's position is that Lumber Liquidators should have known that it *might* be purchasing illegally sourced wood given how Xingjia conducts its business. Although EIA alleges improper business practices by Xingjia (Compl. ¶ 88), provides evidence that Lumber Liquidators purchased solid oak flooring from Xingjia that comes from the RFE (*id*. ¶¶ 89, 92), and reports that Company personnel have visited Xingjia's offices and sawmills (*id*. ¶¶ 93, 94), notably missing is any evidence that Lumber Liquidators actually purchased any illegally sourced wood from Xingjia in violation of the Lacey Act.[12]

Finally, the Complaint's insistence that Lumber Liquidators' increases in gross margin as compared to Home Depot and Lowe's somehow demonstrates that the Company must have engaged in regulatory violations is simply nonsensical. (Compl. ¶¶ 9-10, 58, 103.) Home Depot and Lowe's sell a vast array of non-flooring products, including building materials, home improvement products, paint, lawn, and garden items, and related services. (Home Depot 2012 Form 10-K at 1, Ex. 4; Lowe's 2012 Form 10-K at 6, Ex. 5.) Indeed, Lumber Liquidators estimates that its "product categories represent less than 2% of sales at an average Home Depot or Lowe's store." (2013 Form 10-K at 8, Ex. 1.) As a result, any comparison between the gross margin of Home Depot/Lowe's and the gross margin of Lumber Liquidators is a meaningless apples-to-oranges comparison.[13]

In sum, nothing in the Zhou Post, the EIA Report, or the mere fact that the Company's gross margins increased supports Plaintiffs' theory that the Company's public disclosures were false because Defendants "consistently violated federal law."

[12] Plaintiffs identify one declaration form in an effort to establish a single, possible Lacey Act violation by Lumber Liquidators. (Compl. ¶ 102.) The EIA Report, however, states that the form was provided to EIA by Greenhome, a Lumber Liquidators supplier, and Plaintiffs provide no factual allegations suggesting that Lumber Liquidators ever saw it. (EIA Report at 21.) Moreover, because the form is an unsigned draft, Plaintiffs have failed to establish that it was ever actually filed and, accordingly, that any Lacey Act violation occurred.

[13] As these numbers suggest, changes in the product costs or sales revenues of hardwood flooring experienced by Home Depot and Lowe's would, as compared to Lumber Liquidators, have a minimal effect on those companies' gross margins.

C. The Supposed Existence of Regulatory Violations Does Not Make Any of the Alleged Misstatements False

Plaintiffs assert that the Company's failure to disclose the existence of supposed CARB and Lacey Act violations rendered all of its statements about regulatory compliance and financial performance false. Even assuming, *arguendo*, that Plaintiffs had adequately pled that widespread violations occurred (which they have not), the mere existence of the violations do not demonstrate falsity. *Longman v. Food Lion, Inc.*, 197 F.3d 675, 682 (4th Cir. 1999) (plaintiffs must adequately plead that omitted information rendered statements misleading).

1. Alleged False Statements Regarding Regulatory Compliance

Plaintiffs allege that Lumber Liquidators' statements concerning its regulatory compliance were false. (Compl. ¶¶ 112, 118, 142, 153, 155, 178, 188, 194). These statements, however, generally fall into two categories: (a) statements of *fact* concerning the Company's compliance policies, personnel, and activities (*e.g.*, Compl. ¶ 188 ("The Company has more than 60 professionals around the world who perform and monitor those processes.")), and (b) statements of *opinion* that the Company has a strong quality control and assurance program and conducts its activities in compliance with the law (*e.g.*, *id.* ¶ 112 ("We believe that we currently conduct … our activities and operations in substantial compliance with the law.")). As to the statements of fact, the mere existence of regulatory violations does not establish that Lumber Liquidators *lacked* compliance policies, personnel, and activities. As to the statements expressing the Company's opinions regarding its regulatory compliance, a statement of opinion is only false "if the statement is false, disbelieved by its maker, and related to matters of fact which can be verified by objective evidence." *Nolte v. Capital One Fin. Corp.*, 390 F.3d 311, 315 (4th Cir. 2004). Plaintiffs fail to plead any facts establishing that the senior corporate officers who made these statements did *not* believe that Lumber Liquidators had a strong quality control and assurance program or was conducting its activities in substantial compliance with the law. *See also* § III *infra*.

2. Alleged False Statements Regarding Financial Performance

Plaintiffs allege that every statement Lumber Liquidators made about its increase in gross margins and overall financial performance was false because the Company did not disclose that CARB and Lacey Act violations were contributing to those results. (*See* Compl. ¶¶ 105-06, 108, 110, 114, 116, 120-21, 123, 126-27, 129, 132, 134, 136-37, 139, 144-45, 147, 149, 151, 157, 159, 161-62, 164, 171-72, 174, 176, 181, 183, 191-92). In particular, all of these financial statements are alleged to be false because the supposed regulatory violations caused "the decrease in the Company's cost of product and increase in margins," "a substantial portion of the Company's earnings and revenues were thereby earned as a result of the violation of these laws," and "the Company's gross margin expansion was not sustainable." (*Id.* ¶ 104.) The problem with this sweeping accusation of financial fraud is that it cannot be substantiated by the actual allegations. There are at least two major, insurmountable flaws in Plaintiffs' pleading.

First, nowhere in the Complaint is it alleged that the flooring tested in the Zhou Post or any oak hardwood illegally harvested in RFE was actually cheaper than similar, compliant products. The Complaint appears to assume that this is true, but offers no factual allegations in support of that assumption (indeed, the Zhou Post and EIA Report make no mention of the products being cheaper). *See Ashcroft v. Iqbal*, 556 U.S. 662, 679 (2009) (allegations that permit court to infer only "the mere possibility of misconduct" are insufficient). Under these circumstances, Plaintiffs have failed to adequately plead that the alleged regulatory violations lowered Lumber Liquidators' product costs and thereby increased its gross margins.

Second, Lumber Liquidators' revenue totaled over $1 billion in 2013. (2013 Form 10-K at 24-27, Ex. 1.) Even assuming that Mr. Zhou did find a single box of noncompliant flooring—and this is far from clear—this fact utterly fails to demonstrate any significant financial impact from CARB violations. Plaintiffs' apparent bald assumption that if the flooring in one box violates CARB, the flooring in other boxes also must violate CARB, obviously does not satisfy Plaintiffs' pleading burden. Similarly, any possible Lacey Act violations related to Lumber Liquidators' purchase of RFE oak could not have affected a "substantial portion" of the Company's revenue. As the Company has disclosed, only 1.6% of its hardwood purchases (which, in turn, only make up 41% of its overall product purchases) consist of oak purchased from northern China. (CSFB presentation at 24, attached to the Company's December 9, 2013 Form 8-K, Ex. 2.) In other words, less than 1% of the Company's overall purchases of products are possibly implicated by EIA's investigation into RFE logging and Xingjia. Even if every piece of oak that Lumber Liquidators purchased from Xingjia were illegally sourced, these purchases and subsequent sales to consumers would account for an extremely small portion of the Company's revenues, not a "substantial" one.

Plaintiffs' failure to allege facts establishing that CARB or Lacey Act violations had any impact (and certainly no significant impact) on Lumber Liquidators' financial performance means that their claims based on the Company's financial disclosures must be dismissed. *See, e.g., Gross v. Summa Four, Inc.*, 93 F.3d 987, 995-96 (1st Cir. 1996), *superseded by statute on other grounds as stated in Greebel v. FTP Software, Inc.*, 194 F.3d 185, 197 (1st Cir. 1999) (general allegation that certain practices affected company's earnings are insufficient under Rule 9(b); plaintiff failed to offer particular allegations because he did "not allege[] the amount of the putative overstatement or the net effect it had on the company's earnings"); *In re Daou Sys., Inc.*, 411 F.3d 1006, 1016-18 (9th Cir. 2005) (plaintiff must specifically plead effect of alleged misconduct on company's revenues).

3. Defendants Had No Duty to Disclose the Information that Plaintiffs Claim Was Omitted

Even if the supposed regulatory violations did have some financial impact on Lumber Liquidators, it is well-established that the Company was not required to disclose the existence of those violations. Plaintiffs do not allege that any of the financial results reported by Lumber Liquidators, including its gross margins, were inaccurate. *Electrical Workers Pension Trust Fund of IBEW Local Union No. 58 v. CommScope, Inc.*, 2013 WL 4014978, at *15 (W.D.N.C. Aug. 3, 2013) ("Plaintiff has alleged no facts to dispute that these numbers are accurate, nor is it the Court's understanding that they challenge the validity of the figures in any respect. Therefore, the recitation of a mere fact about the financial results of a company to its investors is not false and, taken independently, cannot be misleading."). Instead, they assert that the

Company had a duty to disclose that these financial results were the result of illegal activities. As numerous courts have held, however, no such duty exists. *Iron Workers Local 16 Pension Fund v. Hilb Rogal & Hobbs Co.*, 432 F. Supp. 2d 571, 586-87 (E.D. Va. 2006) (companies have no "duty to disclose illegal and illicit activities"); *In re Citigroup, Inc. Sec. Litig.*, 330 F. Supp. 2d 367, 377 (S.D.N.Y. 2004) ("[F]ederal securities laws do not require a company to accuse itself of wrongdoing."); *Weill v. Dominion Res., Inc.*, 875 F. Supp. 331, 337 (E.D. Va. 1994) (reasoning that "securities laws do not obligate defendants to reveal the culpability of their activities"). Accordingly, unless Lumber Liquidators "reported income that it did not actually receive, the allegation that a corporation properly reported income that is alleged to have been, in part, improperly obtained is insufficient to impose Section 10(b) liability." *In re Marsh & McLennan Cos., Inc. Sec. Litig.*, 501 F. Supp. 2d 452, 470 (S.D.N.Y. 2006).

Nor can Plaintiffs salvage their claims by asserting that Lumber Liquidators, when it disclosed its gross margins, had a duty to inform the market that they were "not sustainable." (Compl. ¶ 104.) In *Iron Workers*, the plaintiff alleged that the corporate defendant inflated its revenue and earnings by "concealing illicit steering agreements," by not disclosing that "non-standard commissions … represented an important revenue source," and not disclosing "the significant risks that the material portion of its revenue generated by non-standard commissions was subject to fines, penalties, [etc.]" 432 F. Supp. 2d at 576. In response to plaintiff's argument that the corporate defendant had a duty to disclose that "the receipt of non-standard commissions was likely to cease" due to the ongoing investigation, the court found that in the absence of specific statements where the company "guaranteed that revenues would continue," no such duty existed. *Id.* at 586; *see also Raab v. Gen. Physics Corp.*, 4 F.3d 286, 289 (4th Cir. 1993) (holding that "General Physics' accurate reporting of its past results did not ... require the company to speculate on the effect that a contract slowdown at the [Department of Energy] in 1992 would have on its future earnings"). As in *Iron Workers*, Lumber Liquidators provided investors with no guarantees about its gross margins, and it therefore cannot be held liable for allegedly failing to disclose that they were "not sustainable."

III. Plaintiffs Do Not and Cannot Plead a Strong Inference that Any of the Defendants Acted with Scienter

Plaintiffs have not adequately pled that any of the public statements at issue are false or misleading. *See supra* § II. Because the statements were not false, Defendants obviously could not have *known* that they were false, and Plaintiffs' claims must be dismissed.

Even assuming, *arguendo*, that Plaintiffs have adequately pled the existence of false statements, the factual allegations in the Complaint fail to establish the required "strong inference" that any of the Defendants acted with scienter.[14] The Complaint identifies no document, witness, or other piece of evidence establishing that any individual Defendant—or anyone else at the Company—knew or was severely reckless in not knowing of the supposed regulatory violations and their alleged impact on Lumber Liquidators' financial performance. Indeed, the most compelling inference to be drawn from a holistic analysis of all of the facts properly before this Court is that, even assuming regulatory violations occurred, Defendants acted innocently in making the Company's public disclosures.

A. Plaintiffs Offer No Allegations Establishing a Strong Inference that Defendants Were Aware of Any CARB Violations

Plaintiffs appear to have done no independent factual investigation regarding formaldehyde emissions from the Company's products. Instead, they rely exclusively on the Zhou Post. Nothing in that post, however, establishes any inference of scienter as to CARB violations. The fact that *one* sample of Lumber Liquidators' flooring products may have exceeded CARB's standards obviously does not demonstrate that Defendants were aware of any violations. Nor does the Zhou Post identify any red flags that should have alerted Defendants to an ongoing formaldehyde emissions problem.

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[14] For a corporation to have acted with the requisite scienter, at least one of its agents that made the false or misleading statement must have acted with scienter. *See Hunter*, 477 F.3d at 184 (strong inference of scienter required for "at least one authorized agent of the corporation") (citing, *inter alia*, *Southland Sec. Corp. v. INSpire Ins. Solutions, Inc.*, 365 F.3d 353, 363-67 (5th Cir. 2004) (corporate scienter for false statements determined by "look[ing] to the state of mind of the individual corporate official or officials who make or issue the statement" or are closely involved with making it). The scienter of a corporate officer or employee who is *not* involved in making a false or misleading statement cannot be attributed to the corporation for the purposes of that statement. *See, e.g.*, *In re Computer Sciences Corp. Sec. Litig.*, 890 F. Supp. 2d 650, 664-65 (E.D. Va. 2012) (rejecting argument that scienter of corporate agents who did not make the statements in question could be imputed to corporation).

Indeed, the Complaint's allegations regarding CARB violations are more notable for what they do not contain. If Lumber Liquidators' products emitted formaldehyde at excessive, dangerous levels, one would have expected the Zhou Post to unleash a public outcry and regulatory actions. Instead, the Zhou Post has been roundly criticized by other market observers (*see supra* Section I), and Plaintiffs do not allege that any regulatory actions have been brought against the Company. In addition, none of the confidential witnesses cited in the Complaint discuss CARB compliance or assert that anyone at the Company was aware of CARB compliance issues. These "omissions" cut strongly against any inference of scienter. *See Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 326 (2007) ("omissions and ambiguities count against inferring scienter").

B. Plaintiffs Offer No Allegations Establishing a Strong Inference that Defendants Were Aware of Any Lacey Act Violations

Assuming, *arguendo,* that Plaintiffs have adequately pled that Lumber Liquidators purchased illegally harvested oak from the RFE, they face a formidable burden in pleading that Defendants knew, or were severely reckless in not knowing, that this had taken place. After all, neither the Complaint nor the EIA Report alleges that *Lumber Liquidators* engaged in illegal harvesting. Rather, the supposed illegal harvesting was at the very beginning of the supply chain, when the oak was harvested, and therefore prior to the wood being bought by Xingjia, processed, and allegedly re-sold as flooring to Lumber Liquidators. (*See, e.g.*, Compl. ¶¶ 40-46, 81-83; EIA Report at 6-8.) The relevant issue is thus whether Defendants knew that any Russian oak the Company purchased from a supplier had been illegally harvested by *someone else*.

The Complaint contains no direct allegations concerning the Defendants' knowledge of this supposed illegal harvesting. In particular, Plaintiffs cite no former employee statements or company documents that would support an inference that any individual Defendant was aware that the hardwood the Company imported from northern China had been illegally sourced in the RFE. *See, e.g.*, *ECI Telecom*, slip op. at 7, Ex. 18 ("Because plaintiffs have clearly obtained the cooperation of former [defendant] employees, this Court expects that plaintiffs should be able to articulate these claims with the requisite specificity.”). Instead, Plaintiffs rely on circumstantial allegations that are clearly deficient.

First, Plaintiffs suggest that Defendants must have known that some of the wood the Company purchased was illegally harvested because the oak purchases came from the RFE. The bare fact that oak comes from the RFE, however, has no bearing on its legality. As the Complaint concedes, it is perfectly legal to harvest timber in the RFE in certain areas and subject to permits. (Compl. ¶ 42.) Even under the World Wildlife Fund’s most recent estimate, only 50% of the oak exported from the RFE is done so illegally, which leaves another 50% that can be properly imported by a U.S. company.[15] (EIA Report at 7.)

Second, Plaintiffs appear to suggest that the fact that certain agencies of the U.S. government executed search warrants at the Lumber Liquidators headquarters supports an inference of scienter. (Compl. ¶¶ 15, 185-86.) The execution of search warrants, however, only indicates that the government has initiated an investigation, and a mere investigation is “too speculative to add much, if anything, to an inference of scienter.” *Cozzarelli*, 549 F.3d at 630 n.2; *see also In re BearingPoint, Inc. Sec. Litig.*, 525 F. Supp. 2d 759, 777 (E.D. Va. 2007), *rev’d and remanded on other grounds sub nom. Matrix Capital Mgmt. Fund, LP v. BearingPoint, Inc.*, 576 F.3d 172 (4th Cir. 2009) (“Inferring scienter from the mere existence of an investigation would be an end-run around the stringent pleading requirements of the PSLRA, entitling every plaintiff who brought suit against a company under investigation access to discovery.”).

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[15] The Complaint also contends that Lumber Liquidators would have learned the “truth” if it had entered certain specific terms into the Russian version of Google. (Compl. ¶ 84.) Moreover, CW5 speculates that, if Lumber Liquidators had called an unidentified “forest enforcement office,” someone at that office would have confirmed Xingjia’s involvement in illegal logging. (Compl. ¶ 85.) Of course, as the Complaint implicitly concedes, such actions would not have demonstrated that any of the wood actually being purchased by Lumber Liquidators had been illegally harvested. *See, e.g.*, *In re Galileo Corp. Shareholders Litig.*, 127 F. Supp. 2d 251, 264-65 (D. Mass. 2001) (“Recklessness … involves more than a failure to investigate, even in the face of warning signs of trouble. … Because at the most the plaintiffs here have alleged only that the defendants failed to discover warnings about Imagyn’s financial condition, the plaintiffs have failed sufficiently to allege scienter in the form of reckless, as distinguished from negligent, conduct on the part of the defendants.”).

Plaintiffs do not, because they cannot, identify any actual government enforcement action indicating that the government has uncovered evidence of intentional wrongdoing at the Company.

Third, Plaintiffs focus on visits by Lumber Liquidators' personnel to Xingjia facilities. (*See, e.g.*, Compl. ¶¶ 86-88, 93-94.) In particular, Plaintiffs allege that EIA investigators were given a tour of the Xingjia facilities during which Xingjia officials allegedly confessed to illegal conduct, and that Lumber Liquidators employees were at some point given a "similar" tour. (Compl. ¶¶ 9, 88, 93-94.) But at no point do Plaintiffs allege that the Xingjia officials made the same confessions to Lumber Liquidators' employees (even though this would have been an obvious follow-up question for the EIA investigators to ask). *See, e.g.*, *In re Winn-Dixie Stores, Inc. Sec. Litig.*, 531 F. Supp. 2d 1334, 1350 (M.D. Fla. 2007) ("[I]t is not enough to make conclusory allegations that Defendants had access to the 'true facts' in order to demonstrate scienter, particularly when the complaint fails to allege which defendant knew what, how they knew it, or when."). Nor do Plaintiffs allege what the Company's employees allegedly heard or saw at the Xingjia facilities, or that anything they saw actually was communicated to any Company officials who made the alleged false statements.[16] *Plumbers and Pipefitters Local Union 719 Pension Fund v. Zimmer Holdings, Inc.*, 2011 U.S. Dist. LEXIS 9253, at *59 (S.D. Ind. Jan. 28, 2011) (plaintiff's allegation that defendants' representatives were present and may have witnessed company problems failed to support strong inference of scienter).

[16] Although Plaintiffs attempt to place Mr. Schlegel on site during these visits, Mr. Schlegel had nothing to do with the public disclosures at issue, and his mental state thus cannot be attributed to any other Defendant for purposes of a Rule 10b-5 claim. *See Computer Sciences Corp.*, 890 F. Supp. 2d at 664-65 (corporation's scienter cannot be established by scienter of individuals not involved in public statements). Moreover, because Mr. Schlegel had no involvement with the public statements, the claims against him must be dismissed. Under Supreme Court precedent, only the "maker" of a false or misleading statement can be held liable under Rule 10b-5 for making false statements. *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2302 (2011). "For purposes of Rule 10b–5, the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it." *Id.* Plaintiffs do not allege that Mr. Schlegel made—or even had any involvement with—any of the alleged misstatements at issue, much less do they offer any allegations that he wielded "ultimate authority" over them. (*See* Compl. ¶¶ 104-202.)

Fourth, Plaintiffs rely on hearsay statements from an undescribed confidential witness. According to the Complaint, EIA asked Mr. Yu directly whether Lumber Liquidators was aware of any illegal harvesting. (Compl. ¶ 91.) Whatever Mr. Yu said in response to this question is omitted from the Complaint. Rather, the Complaint states that "the son-in-law" opined that Lumber Liquidators is aware of the illegal harvesting. (Compl. ¶ 91.) "The son-in-law" is mentioned nowhere else in the Complaint. Plaintiffs do not explain whose son-in-law this person is, what position he holds at Xingjia (if any), or why he is in a position to speak reliably about Lumber Liquidators' knowledge. Courts in this district routinely reject these types of allegations in assessing the pleading of scienter. *See, e.g.*, *Carlucci v. Han*, 886 F. Supp. 2d 497, 519-20 (E.D. Va. 2012) ("There are no allegations that the energy consultant attended any meetings, reviewed any documents, spoke with anyone at Petrobas, or spoke with [the defendant] himself. Nor is there a description of the energy consultant's relationship with [the defendant] or the purpose of their trip. In short, Carlucci's conclusory allegations fail to support the probability that the energy consultant possessed the information alleged.").

Finally, Plaintiffs point to an alleged "fraudulent Lacey Act Declaration" that identifies Lumber Liquidators as the source of wood with a misidentified source. (*Id.* ¶ 102.) The EIA Report, however, discloses that the document was provided by Greenhome, not by Lumber Liquidators. (EIA Report at 21.) Moreover, the declaration, which is ultimately supposed to be filled out, signed, and filed with the U.S. Department of Agriculture, *see* 16 U.S.C. § 3372(f), is unsigned. This strongly suggests that it was never filed or approved for filing, and Plaintiffs offer no allegations to suggest that Lumber Liquidators was ever made aware of this document (even in draft form).[17]

[17] Plaintiffs also contend that, according to Greenhome, Lumber Liquidators declared all Greenhome products as German because the U.S. market and government "don't like" wood from Russia. (Compl. ¶ 101.) This is a hearsay statement from an unidentified source, and the Complaint provides no facts to suggest that this anonymous source would be in a position to speak reliably on this topic. *See, e.g., Carlucci,* 886 F. Supp. 2d at 519-20 (rejecting allegations of confidential witness for failure to allege how witness would possess information in question). Moreover, neither EIA nor Plaintiffs have managed to find a single customs filing that substantiates this statement, other than the one unsigned, apparently unfiled draft form provided to EIA by Greenhome. (EIA Report at 21.)

C. Plaintiffs Do Not Adequately Allege that Defendants Acted with Scienter in Making Any Statements About the Company's Financial Performance

Plaintiffs' overall theory of fraud is that the Company's gross margin increases were driven by its importation of illegal products. (*See, e.g.*, Compl. ¶ 2.) Having failed to establish any strong inference of scienter as to CARB and Lacey Act violations, however, Plaintiffs have obviously failed to establish that the Defendants knew the Company's financial statements were misleading as a result of those violations. Indeed, the Complaint contains no particularized facts concerning the impact of the supposed regulatory allegations on the Company's gross margins, let alone that Defendants knew about this impact. The Tilson Presentation, which appears to be the sole source of the Complaint's financial allegations, also makes no reference to what any individual Defendant would have known, cites no internal sources or documents, and even disclaims its own accuracy. (*See, e.g.*, Tilson Presentation at 3, Ex. 16.) In sum, none of the allegations in the Complaint rebut the competing inference that Defendants innocently (and correctly) attributed their increased gross margins to normal business developments. *See, e.g.*, *Davis v. SPSS, Inc.*, 385 F. Supp. 2d 697, 716 (N.D. Ill. 2005) (where "complaint provides factual allegations of [] knowledge of improper practices," but does not establish "what relevance they had on [the company's] bottom line," the court cannot make "leap" of assuming that knowledge of such improper practices establishes that defendants knowingly misrepresented financial statements).

D. The Individual Defendants' Stock Sales are Not Unusual or Suspicious

Specific facts demonstrating motive and opportunity may be relevant to the issue of scienter, but usually are insufficient to establish a strong inference of scienter by themselves. *In re PEC Solutions Sec. Litig.*, 2004 WL 1854202, at *13 (E.D. Va. May 25, 2004), *aff'd*, 418 F.3d 379 (4th Cir. 2005). Here, Plaintiffs' only motive allegation is that the individual Defendants sold their Lumber Liquidators stock during the Class Period and therefore had a "motive" to artificially inflate the stock price by making false statements. In the Fourth Circuit, however, "[i]nsider trading allegations will *only* support an inference of scienter if the timing *and* amount of a defendant's trading were unusual or suspicious." *Yates*, 744 F.3d at 890 (emphases added). Courts have routinely found that even large stock sales—large in terms of total amount or as a percentage of the seller's holdings—are not suspicious when plaintiffs fail to adequately allege that the timing of the sales was "calculated to maximize the personal benefit from undisclosed inside information." *See, e.g., Ronconi v. Larkin,* 253 F.3d 423, 435 (9th Cir. 2001) (sales by seven insiders of "sixty-nine percent or more of their total stock and options" were not suspicious because insiders did not sell their shares at price near class period high).

An examination of the exact timing of the sales by Defendants Lynch, Terrell, Sullivan, and Schlegel undermines any suggestion that they were suspicious.[18] As demonstrated in the chart and Form 4s attached as Exhibits 19 and 19a-d, nearly 50% of the shares sold by Defendants were sold at prices *below* $50, and nearly 90% of the shares sold by Defendants were sold at prices *below* $90. The class period high was $119.44. As the Ninth Circuit found in *Ronconi*, "[w]hen insiders miss the boat this dramatically, their sales do not support an inference" that they are defrauding the public. 253 F.3d at 435. This Court should reach the same conclusion.

IV. Plaintiffs Fail to Adequately Plead Loss Causation

Under the PSLRA, a plaintiff bears the burden of adequately pleading "loss causation"—"*i.e.*, that the defendant's material misrepresentation or omission 'caused the loss for which the plaintiff seeks to recover damages.'" *Katyle v. Penn Nat'l*, 637 F.3d 462, 465 (4th Cir. 2011) (citations omitted). To satisfy this pleading burden, a plaintiff must plead "a sufficiently direct relationship" between the plaintiff's loss and the alleged fraudulent conduct. *Id*. at 472. This "direct relationship" must be pled with "sufficient specificity," a standard consistent with Fed. R. Civ. P. 9(b)'s requirement that fraud allegations be pled with particularity. *Id*. at 471. "The degree of specificity demanded is that which will 'enable the court to evaluate whether the necessary causal link exists.'" *Id.* (citations omitted).

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[18] Plaintiffs also contend that the Company's insiders engaged in two "coordinated dumps" of stock. (*See* Compl. ¶¶ 210-13.) This allegation fails to move the needle toward scienter. It is common for a company to impose "blackout periods" and "trading windows" on its insiders' stock sales. A "blackout period" is "a period when a public company's directors, officers, and specified employees cannot trade the company's stock. Blackout period[s] occur prior to the release of annual or quarterly financial earnings information, and may extend for a time period after the release of the earnings information." *Dialog4 Sys. Eng'g GmbH v. Circuit Research Labs, Inc.*, 622 F. Supp. 2d 814, 818 n.1 (D. Ariz. 2009) (quoting *Webster's New World Finance and Investment Dictionary* (2003)). A "trading window" refers to the time in between blackout periods in which insiders are permitted to sell their stock. The Company's Insider Trading Policy establishes a trading window that opens three days after an earnings release and closes thirty days before the end of the quarter. (Lumber Liquidators Holdings, Inc. Insider Trading Policy at 3, Ex. 20, publicly available at http://investors.lumberliquidators.com/corporate-governance (last visited Aug. 18, 2014).) Both of the supposed "coordinated dumps" by the Company's insiders took place during these open windows—these are thus the only times that insiders *could have* sold. (Compl. ¶¶ 161-62, 171-72, 210-13.)

In this case, the Complaint purports to establish loss causation by alleging the existence of certain "corrective disclosures" that led to stock price declines. Corrective disclosures, however, must be adequately alleged to have revealed "*new facts* suggesting [the defendant] had perpetrated a fraud on the market"—that is, the newly disclosed facts "must reveal to the market in some sense the fraudulent nature of the practices about which [the] plaintiff complains." *Id.* at 473 (emphasis added). For the reasons shown below, Plaintiffs' allegations of "corrective disclosures" cannot satisfy their pleading burden.

The Zhou Post. Plaintiffs first point to the Zhou Post on June 22, 2013, in which Zhou claims that *one* of two wood samples he tested emitted excessive formaldehyde. As a threshold matter, an individual plaintiff in a securities class action must plead a "'necessary causal link' between the defendant's alleged fraud and *the plaintiff's* economic harm." *Id.* at 472 (citing *Dura Pharm.*, 544 U.S. at 346 (2005)) (emphasis added); *Rutan v. Republican Party of Ill.*, 868 F.2d 943, 947 (7th Cir. 1989) (in reviewing motion to dismiss for failure to state claim, "we treat plaintiffs' claims as being brought solely by the named plaintiffs") (citation omitted), *rev'd in part on other grounds*, 497 U.S. 62 (1990).

Here, Plaintiff Foster allegedly purchased 900 shares of Lumber Liquidators stock on November 22, 2013, the last day of the Class Period. Plaintiff Kiken allegedly purchased 500 call options for Lumber Liquidators stock on September 26, 2013. Thus, neither Plaintiff here owned Lumber Liquidators stock prior to the Zhou Post on June 22, 2013. As such, the decline in stock price that Plaintiffs attribute to the Zhou Post could not possibly have harmed Plaintiffs. The Zhou Post is therefore irrelevant to the issue of whether there exists the "necessary causal link" between "defendant's alleged fraud and the plaintiff's [*i.e.*, Kiken's and Foster's] economic harm." *Katyle*, 637 F.3d at 472 (citing *Dura*, 544 U.S. at 346) (emphasis added). To adequately plead *that* requisite causal link, Plaintiffs obviously cannot rely on "corrective disclosures" that pre-date their stock purchases.

Even if the Court needed to consider whether the Zhou Post constituted a "corrective disclosure," it is clear that the Zhou Post did not "reveal" the "fraudulent nature of the practices about which the plaintiff complains." *Katyle*, 637 F.3d at 473. These alleged "practices" are the supposed scheme to improperly inflate the Company's gross margins through the "consistent" importation of illegal wood, including wood that containing excessive levels of formaldehyde. Mr. Zhou's post—by merely claiming that one isolated sample of the Company's product exceeded the CARB standard in California—did not in any meaningful sense "reveal" the alleged fraudulent practices.

The Ninth Circuit's decision in *Metzler* is instructive. *Metzler Inv. GMBH v. Corinthian Colleges*, 540 F.3d 1049 (9th Cir. 2008). There, the plaintiff alleged that the defendant Corinthian Colleges—a for-profit educational institution with 88 campuses in 22 states—engaged in fraudulent practices to maximize the amount of federal Title IV funding it received. In attempting to satisfy its loss causation pleading burden, the plaintiff alleged (*inter alia*) that the defendant's fraud was revealed by a *Financial Times* story reporting that the Department of Education had investigated *one* of the school's many campuses, found compliance deficiencies, and "placed [it] on 'reimbursement' status" as a result of its financial aid practices. *Id.* at 1057. The Ninth Circuit found that the *Financial Times* story was not a corrective disclosure because it did not "disclose[]—or even suggest[]—to the market that Corinthian was manipulating student enrollment figures *company-wide* in order to procure excess federal funds … [and could not] be reasonably read to reveal *widespread* financial aid manipulation by Corinthian." *Id.* at 1063. The Zhou Post does not amount to a "corrective disclosure" for the exact same reasons.[19]

[19] Even if the Plaintiffs belatedly attempt to argue in their Opposition that Zhou's post was a corrective disclosure because it suggested to the market that there was potentially a larger problem at the Company with CARB compliance, that argument would have no merit. As the Ninth Circuit stated in rejecting the same argument, neither the Supreme Court's ruling in *Dura* nor other precedent "support[s] the notion

The Government's Investigation. Plaintiffs suggest that the Company's September 27, 2013 announcement about the execution of search warrants at the Company's corporate offices constituted a corrective disclosure. (Compl. ¶¶ 2, 15-18, 185-188.) It is well-established, however, that the announcement of a government investigation cannot act as the revelation of a fraud. Indeed, two different Courts of Appeals have recently addressed the issue—the Ninth Circuit just earlier this month, and the Eleventh Circuit last year—and both Courts held the disclosure of an investigation is *not* sufficient. *Loos v. Immersion Corp.*, --- F.3d ---, 2014 WL 3866084, at *8 (9th Cir. Aug. 7, 2014); *Meyer v. Greene*, 710 F.3d 1189, 1201 (11th Cir. 2013). As the Ninth Circuit explained, "at the moment an investigation is announced, the market cannot possibly know what the investigation will ultimately reveal." *Loos*, 2014 WL 3866084, at *8. Any related decline in the stock price "can only be attributed to market speculation about whether fraud has occurred. This type of speculation cannot form the basis of a viable loss causation theory." *Id.*; *see also Caplin v. Trans1, Inc.*, 973 F. Supp. 2d 596, 610 (E.D.N.C. 2013) ("[A]llowing a plaintiff to plead loss causation solely on the basis of an announced investigation encourages the precise abusive litigation practice the securities laws are designed to protect against.").

The Tilson Presentation. Finally, the Complaint suggests that the Tilson Presentation on November 22, 2013 was a corrective disclosure. (Compl. ¶¶ 2, 18-19, 197-98.) But Fourth Circuit law is clear: corrective disclosures must reveal the "truth" through new "*facts.*" *Katyle*, 637 F.3d at 477 (emphasis in original). On its face, the Tilson Presentation is predicated entirely on existing public information about Lumber Liquidators, including the Zhou Post, the EIA report, and the Company's financial disclosures, and it contains no "new facts." Although Plaintiffs note that the Company's stock price dropped after the Tilson Presentation was made (*see* Compl. ¶ 19, 198), a stock price drop that results from a disclosure based on facts that were already known to the market cannot form the basis for loss causation. *See, e.g.*, *Hunter*, 477 F.3d at 187; *Greene*, 710 F.3d at 1195-98.

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that loss causation is pled where a defendant's disclosure reveals a "'risk' or 'potential' for widespread fraudulent conduct." *Metzler*, 540 F.3d at 1064.

That conclusion is not altered just because the Tilson Presentation, as analyst reports generally do, also contained opinions and analysis regarding the previously disclosed information. The Eleventh Circuit recently faced a virtually identical set of allegations—an analyst presentation that led to a stock-price drop—and held that the plaintiffs had failed to adequately allege loss causation. *Greene*, 710 F.3d at 1195-98 (affirming dismissal for failure to adequately plead loss causation). As the Eleventh Circuit found, "the mere repackaging of already-public information by an analyst or short-seller is simply insufficient to constitute a corrective disclosure." *Id.* at 1199. Indeed, "[i]f every analyst or short-seller's opinion based on already-public information could form the basis for a corrective disclosure, then every investor who suffers a loss in the financial markets could sue under § 10(b) using an analyst's negative analysis of public filings as a corrective disclosure. That cannot be—nor is it—the law." *Id.*

As in *Greene*, the Tilson Presentation sets forth some speculative opinions and conclusions about those previously-disclosed facts. (*See, e.g.*, Tilson Presentation at 15, 18, 19, Ex. 16 ("*I believe* that a substantial fraction of LL's gross (and operating) margins expansion is due simply to buying the same product for less"; "*I think* it is likely that a meaningful percentage of the 51% of LL's wood sourced in Asia is from Chinese mills …"; "my *best guess* is that this is a big problem …") (emphases added).) These opinions and conclusions, however, are not "facts" by any stretch of the imagination—nor, tellingly, are they even described as such in the Presentation itself ("I believe …," "I think …," "my best guess …"). Any stock price decline associated with the Tilson Presentation cannot support the existence of loss causation.

CONCLUSION

For these reasons, the Complaint should be dismissed in its entirety and with prejudice.[20]

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[20] Plaintiffs also bring claims against each Individual Defendant under Section 20(a) of the Securities Exchange Act, 15 U.S.C. § 78t(a), which under certain circumstances provides for secondary liability for "control persons," or those who exercised control over another person or entity that violated the securities laws. (Compl. ¶¶ 92-97.) But "a Section 20(a) claim will stand or fall based on the court's decision regarding the Section 10(b) claim." *Plymouth Cnty. Ret. Ass'n v. Primo Water Corp.*, 966 F. Supp. 2d 525, 552-53 (M.D.N.C. 2013); *see also Yates*, 744 F.3d at 894 n.8. Because Plaintiffs have failed to adequately allege any violations of Section 10(b) or Rule 10b-5, *see supra* §§ II-IV, their control person claims must be dismissed as well. *Id.*

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Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that on the 18th day of August, 2014, I will electronically file the foregoing Memorandum in Support of Motion to Dismiss with the Clerk of the Court using the CM/ECF system, which will then send a notification of such filing (NEF) to the following:

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